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January 25, 2005

VIA COURIER

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Procurement of Default Service Supply, D.T.E 04-115

Dear Secretary Cottrell:

Enclosed herewith for filing are the Reply Comments of NSTAR Electric Company in the above referenced matter.

If there are any questions regarding this submittal please do not hesitate to contact me. Thank you for your attention to this matter.

Sincerely,

John K. Habib

John K. Habib

Enclosures

cc: Jeanne Voveris, Hearing Officer
Joseph Rogers, Office of the Attorney General
Service List (via e-mail and hard copy)

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments Re: Procurement of Default Service	))))	D.T.E. 04-115

REPLY COMMENTS OF NSTAR ELECTRIC

Date: January 25, 2005

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments Re: Procurement of Default Service	D.T.E. 04-115

REPLY COMMENTS OF NSTAR ELECTRIC

I. INTRODUCTION

Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company, d/b/a NSTAR Electric ("NSTAR Electric" or the "Company") hereby submit reply comments in relation to the Request for Comments issued by the Department of Telecommunications and Energy (the "Department") on December 6, 2004, regarding the procurement of default service ("Default Service") power supply for residential and small commercial and industrial ("C&I") customers. The Company's reply comments respond to the recommendations made by a number of interested parties that filed initial comments with the Department on January 1, 2005.[1]

As noted in the Company's initial comments, and reiterated in comments submitted by others in this proceeding, the Department's existing Default Service procurement practices achieve a good balance for customers in terms of ensuring that

1 The Company is in receipt of initial comments submitted by: Cape Light Compact ("CLC"); Constellation Energy Group, Inc. ("Constellation"); Direct Energy Services, LLC ("Direct Energy"); Massachusetts Division of Energy Resources ("DOER"); Dominion Retail, Inc. ("Dominion"); Duke Energy North America ("Duke Energy"); Massachusetts Electric Company and Nantucket Electric Company (together, "National Grid"); Morgan Stanley Capital Group ("Morgan Stanley"); Office of the Attorney General ("Attorney General"); Select Energy, Inc. ("Select Energy"); Strategic Energy, LLC ("Strategic Energy"); Union of Concerned Scientists ("UCS"); Unitil Service Corp. ("Unitil"); and Western Massachusetts Electric Company ("WMECo").

prices are market-driven without exposing customers to the full extent of price volatility on the market. See, e.g., Constellation at 2; National Grid at 3-4; Select Energy at 3; Strategic Energy at 4; WMECo at 3. Notwithstanding the general support for the Department's existing Default Service procurement practices, commenters in this proceeding have offered a number of recommendations for change. Some of these changes would be significant and would represent a fundamental shift in the Department's approach to the procurement of Default Service supply for residential and small C&I customers. As discussed below, the Department should refrain from adopting large-scale changes that are of questionable benefit and have the potential to create undue administrative burdens, added complexity and increased costs for customers.

In that regard, the Department has identified "two equally important principles that serve as guidelines for the design and implementation of default service." Default Service, D.T.E. 02-40-B at 30. These principles are that: (1) Default Service should be provided in a manner that is compatible with the present development and future sustenance of an efficient market structure for retail generation service; and (2) for those customer classes for whom an efficient competitive retail market may not be available, Default Service should be provided in a manner that ensures that electric service will be available at a reasonable price. Id. Accordingly, in these comments, NSTAR Electric will discuss whether the recommended changes have the potential to serve these important public-policy objectives.

IV. NSTAR ELECTRIC RESPONSE TO COMMENTS ON DEPARTMENT QUESTIONS

Below, the Company responds to the recommendations offered in the initial comments relating to the Department's Request for Comments:

(1) Would smaller customers be better served if power supply for Default Service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure Default Service supply.

In response to this question, several commenters recognized that there are two interrelated components of the procurement process that bear on the level of price stability achieved for smaller customers, which are the number of solicitations and the duration of the supply term. See, e.g., Constellation at 3; DOER at 9; National Grid at 2, 4; NSTAR Electric at 9; Select Energy at 2-3; Strategic Energy at 4; WMECo at 7-9. That is, if Default Service supply is procured through an increased number of solicitations, a smaller portion of the Default Service load will be subject to market price changes at any given time, which will tend to enhance the level of overall price stability experienced by customers (i.e., price changes that do occur will be of a lesser magnitude). See .e.g., National Grid at 4-6; NSTAR Electric at 11-12; WMECo at 8.

However, there are two countervailing considerations, which are that (1) the resulting price signal will tend to be less representative of the market price at any point in time; and (2) Default Service customers will experience rate changes that are more frequent than the current semi-annual price changes, unless the contract terms are extended beyond a term of one year. Id.; Constellation at 3; Strategic Energy at 5. In addition, some commenters noted that more frequent solicitations will have the effect of increasing transactional costs and administrative burdens. See, e.g., Constellation at 3; Select Energy at 2-3.

Thus, the Department must balance the desire to achieve a greater level of price stability with the desire to establish a price that is representative of market prices and provides a level of rate continuity for customers. If the Department were to determine that, on balance, it would be desirable to achieve greater price stability by procuring the default service supply in smaller tranches, it will have to also make determinations on the frequency of price changes and/or the length of contract terms. In that regard, NSTAR Electric agrees with other commenters that the existing procurement schedule achieves a relatively high level of price stability, while maintaining a reasonably close connection to wholesale market prices, and therefore, represents an appropriate balance of public policy objectives. See, Constellation at 3; DOER at 9; National Grid at 2, 4; NSTAR Electric at 9; Select Energy at 2-3; Strategic Energy at 4; WMECo at 7-9.

NSTAR Electric would like to comment directly on a number of statements and claims made by the Attorney General in relation to the benefits of dividing the load into a greater number of (smaller) tranches. Specifically, the Attorney General claims that more frequent solicitations would create a "portfolio" of contracts that "could reduce the price to customers, assuming suppliers were willing to lower prices for longer guarantees of price support." Attorney General at 5. However, it is not the Company's experience that suppliers are willing to offer lower prices for longer-term contracts.

In fact, the converse is true – the longer the term, the more risk involved for suppliers and the higher the price. This is because longer-term contracts tend to incorporate a risk premium that would have the effect of increasing costs, not reducing costs, for customers. See, e.g., Constellation at 4-6; Select Energy at 3; Strategic Energy at 6. For example, today's capacity prices are relatively low. If new markets for capacity are implemented by ISO-NE, the price of capacity will rise. Consequently, longer-term contracts will incorporate a premium to compensate the supplier for the risk associated with the regulatory uncertainty relating to future capacity prices. Similarly, longer term contracts will incorporate a premium to compensate the supplier for the risk associated with future energy prices, which become more uncertain the further out in time suppliers have to price. Id. In fact, lower prices for "longer guarantees of price support" tend to be available in markets where there is a concern that a market for the product or service will not be adequate in the future. This is not the case in the electricity market or other commodity markets.

The Attorney General also states that, "although the number of solicitations would increase to create the portfolio, those solicitations could all be done at one time each year." Attorney General at 5, fn.10. In NSTAR Electric's experience, the level of competition in the market is enhanced by virtue of the fact that the various electric distribution companies are procuring power in the market at different times, in different amounts, and for different time periods. These varying solicitations provide opportunities to a broader spectrum of competitive suppliers because suppliers have the ability to craft a business plan to suit their individual operation and then to pursue the solicitations that best suit their business plan at points in time throughout the year. Conducting all of the solicitations at one time has the potential to diminish the level of competition because it effectively creates an "all or nothing" solicitation in which only the very largest suppliers may be willing or able to participate.

Lastly, the Attorney General advocates for the adoption of a complex purchasing protocol that would involve the procurement of Default Service supply in four segments using a combination of spot purchases and contracts of one to three years in term. Attorney General at 8-9. Although the Company generally agrees that a "laddered" approach has the potential to achieve a higher level of price stability than the existing procurement protocol, NSTAR Electric has a number of concerns with the Attorney General's recommended approach.

First, the use of contracts with a term greater than one year will involve the payment of a risk premium, especially in relation to the use of three-year contracts. This will have the direct effect of increasing costs for customers. In fact, the majority of commenters in this proceeding indicated that contracts in excess of two years would not be advisable because of the risk premium and lack of liquidity in the wholesale markets, which would tend to increase costs for customers. Constellation at 4; DOER at 10; Dominion at 4; National Grid at 7-8; Select Energy at 3; WMECo at 10. Moreover with 60 percent of the Default Service load locked in for a period of two years and greater, the resulting prices will not tend to be reasonably connected to prevailing prices in the market. Thus, rather than facilitating competition, this can make it impossible for competitive suppliers to attract customers when the price of Default Service is lower than the competitive supply.

In addition, the Attorney General's suggested paradigm involves tranches that are relatively small, i.e., a significant portion of the load would be procured in tranches of 10-15 percent of the Default Service load. This level of segmentation of the Default Service load could have a negative affect on price because it would cause the Company to be in the market attempting to procure relatively small amounts of power for long periods of time, which will not tend to attract favorable prices.

Accordingly, NSTAR Electric agrees with the general consensus of the commenters that, in terms of the number of solicitations, the existing procurement methodology is working well in that it achieves a significant level of price stability for customers, while allowing prices to also track the market (which benefits competition). The process is also feasible and efficient from an administrative perspective. If the Department determines that additional price stability is desirable, the Department should provide for solicitations involving 25 percent of the Default Service load for terms of two years, rather than implementing the relatively complex and risky proposal recommended by the Attorney General. This approach also provides a good result in terms of: (1) achieving a greater level of price stability; (2) maintaining rate continuity for customers; (3) offering simplicity and administrative efficiency; and (4) ensuring that the Default Service price continues to track market prices over the long term.

(2) Would smaller customers be better served if power supply for Default Service was procured for a term longer than twelve months? Please discuss the advantages and disadvantages of using supply terms greater than twelve months. In particular, please discuss:

(a) whether longer contract terms are likely to produce lower prices;

(b) how such an approach would affect price certainty and market efficiency, and

(c) how such an approach could be tailored to accommodate customer migration to competitive supply.

In general, commenters in this proceeding agree that long-term contracts (i.e., contracts in excess of one-to-two years) are likely to involve the payment of risk premiums over the spot market price for electricity because suppliers must shoulder increased risks related to changing fuel prices, variable loads, regulatory uncertainty and customer migration to and from Default Service. See, e.g., Constellation at 4; DOER at 10; Dominion at 4; National Grid at 7-8; Select Energy at 3; WMECo at 10. In addition, commenters generally agreed that longer-term contracts will have a greater potential to differ from market prices over the course of the contract. Constellation at 5; Select

Energy at 4; Strategic Energy at 6. Accordingly, the benefit of any incremental price stability that would be achieved with a longer-term contract would likely be offset by the increased costs that customers would experience. DOER at 10-12. Therefore, the Department should not require contracts in excess of two years in length.

The Attorney General makes the claim that the advantages of using longer-term contracts (i.e., contracts with 2-3 year terms) include "the possibility of a lower price for default service" and that "longer term contracts could produce lower prices, all other things being equal." Attorney General at 6. As discussed above, there is no basis for this conclusion. Longer-term contracts may provide "price certainty," as the Attorney General asserts, but that price certainty will come at a cost to customers given the structure of the existing generation market, the relative lack of liquidity, and the uncertainties surrounding the ongoing development of market rules. See, e.g., Constellation at 4-6; DOER at 10-12. Moreover, the use of longer-term contracts is likely to result in a price that is unrepresentative of prevailing market conditions, which will be a detriment rather than a benefit to competition as claimed by the Attorney General. Id.

In addition, two commenters recommended that the Department approve the use of contract with terms of 3-5 years or more. Specifically, Morgan Stanley claims that "longer-term contracts of three to five years would mitigate the impact of market fluctuations and help attract more bidders." Morgan Stanley at 4. Similarly, the Union of Concerned Scientists advocates that the Department institute a "laddered" procurement approach utilizing contracts of "medium term" (i.e., 3-5 years) and long-term" contracts (i.e., up to 10 years in term), with a significant portion of the long-term contracts coming from renewable energy generation.[2] UCS at 5.

NSTAR Electric does not believe that the solicitation of longer-term bids will attract more bidders. In fact, the reverse outcome is more likely given future price and regulatory uncertainties that would need to be contemplated in a longer-term contract. Nor will this type of solicitation result in reasonable prices for customers. As noted above, there is a relative lack of liquidity in the New England market for contracts in excess of two years. With fewer bidders, and those who are willing to bid seeking higher prices due to the risk associated with capacity costs, energy prices and load migration, the result will actually be less competition and increased costs to rate payers. Also, suppliers have less ability to hedge their positions when contract terms are relatively longer because there are fewer counterparties willing to take a position in the market. Moreover, the lack of bidders on Default Service contracts, in and of itself, may result in higher prices for small customers to the extent that fewer bidders produces less favorable prices than would likely occur with a more vibrant bid pool. All of these factors will have the direct result of increasing prices for customers and divorcing the Default Service rate from market prices, which will have a negative effect on competition. Accordingly, neither of these recommendations meet the Department's stated objectives for Default Service procurement.

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2 In these comments, NSTAR Electric does not address issues regarding the use of long-term contracts to support or promote the development of renewable energy generation. Although NSTAR Electric is supportive of the efforts of UCS to encourage the development of renewable energy resources and believes that this is an important public-policy issue, these issues have ramifications that reach beyond the parameters of this proceeding, and therefore, require resolution in a docket specifically focused on those issues.

(3) **Would small customers be better served if power supply for Default Service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to Default Service procurement.**

Several commenters recommend that the Department adopt a statewide solicitation or auction process that would involve the coordinated procurement of Default Service supply for all of the electric distribution companies serving customers in the Commonwealth.[3] See, e.g., Attorney General at 7; DOER at 13, Duke Energy at 2; Morgan Stanley at 6; National Grid at 11. As stated in its initial comments, NSTAR Electric does not believe that smaller customers would be better served if power were procured on a statewide basis for Default Service because there are no benefits to be gained through the establishment of a statewide process, and instead, it is more likely that additional cost will be involved for customers.

In addition, the move to a statewide solicitation may attract some suppliers, but is likely to be a detriment to other suppliers that are able to participate in the current structure but perceive a statewide procurement scheme as leading to greater transaction costs or greater uncertainty in terms of process and contracting issues. For example, if a statewide entity is procuring the power, it is unclear who the counterparty to the supply contract would be in terms of credit quality and contract administration. Accordingly, in considering these proposals, the Department should evaluate closely the claimed benefits and costs of such an approach, and move to make a change only if it determines that there are net incremental customer benefits to be gained through the implementation of such a

[3] Dominion advocates for a "retail auction," which would aggregate customers and move them to competitive supply. Dominion at 6. This proposal would require legislative action and falls outside the scope of the Department's Request for Comments, and therefore, NSTAR Electric makes no comment on this proposal.

structure.

In that regard, commenters recommending the adoption of a statewide solicitation process cite one primary benefit, which is that uniform prices for Default Service could be established across the state or across load zones thereby eliminating a barrier to competition by eliminating utility-to-utility price differentials for retails competitors (Attorney General at 7; National Grid at 12; DOER at 13). DOER states that price differences create a "serious barrier to retail competition" because a supplier's product may be more competitive in some territories than others, and therefore, the supplier cannot compete across the state with "equal vigor" and cannot justify investments in advertising and marketing in equal amounts across the state. DOER at 13. According to DOER, unified or coordinated procurement could "reduce the visibility and idiosyncrasies of individual [Default Service] procurements by each distribution company. Id. at 14.

In addition to other important issues, a major factor arguing against a uniform default service price is that it is an effort to enhance the ability of suppliers to compete, rather than an effort to structure a framework the encourages the development of sustainable retail competition. The Department has repeatedly emphasized that its role is to establish a framework the enables the development of a competitive market, and not to implement policies designed to enhance the ability of suppliers to compete in that market. Gas Unbundling, 98-32-B at 30 (1999) ("Our role is not to guarantee the success of entrants. Rather, our role is to put in place the structural conditions necessary for an efficient competitive process."); See also, MCI WorldCom, Inc., DTE 97-116-C at 35 (1999).

Significantly, the proponents of the statewide process claim that "suppliers will find it easier to compile their marketing materials when they are competing against a [uniform] Default Service rate" (National Grid at 12) and that the "supplier cannot compete" where "differences in [Default Service] prices from territory to territory [related to the timing or size of the distribution company procurements] make that supplier's product more competitive in some territories than others." DOER at 13. And further, "[c]ompetitive suppliers are forced to tailor their offers to compete with different Default Service prices in different service territories. . . ." Id. Thus, it is clear that the "benefit" of a uniform price would be to help competitors to compete, even if the price established through the process was not appropriate for a given customer. As a result, the claimed "benefit" of a uniform default service price would inure to competitors and not to customers.

In fact, the establishment of a uniform Default Service price would be a step backward in terms of the effect it would have on the competition that has developed to date because it will disconnect the wholesale price from the retail price and it will eliminate the "idiosyncrasies" in pricing that currently exist between the electric distribution companies. These "idiosyncrasies," along with the varying differences in the timing and amount of procurements, actually provide the opportunities for a range of suppliers to compete. In fact, it is the need "to tailor their offers" to these idiosyncrasies that creates opportunities for a variety of suppliers (large and small) to participate in the market based on their individual business plans. Thus, in effect, proponents of a uniform Default Service price are asking the Department to sacrifice all of the progress made in developing competition in the wholesale electric markets in the hope that it will benefit the retail market by making it "easier" for retail suppliers to compete. The Department has clearly articulated its position that its role is not to put in place policies that benefit competitors, but rather to put in place policies that facilitate the development of real and sustainable competition. Thus, the concept of establishing a uniform, statewide averaged price violates one of the Department's founding principles for a competitive market, and should be rejected by the Department.

The Attorney General claims further that a statewide process would allow (1) the "aggregation" of smaller customer groups across utilities to mitigate adverse price impacts associated with loads that are too small to hedge (Attorney General at 7). Morgan Stanley claims that a statewide procurement process with "standardized wholesale contract terms would lower the cost for suppliers to pursue a particular customer base under a single wholesale contract." Morgan Stanley at 6. Morgan Stanley further claims that a statewide process with a standard contract and the opportunity for increased load would lead to greater participation by qualified bidders. Id. However, none of these claims warrant a move to a statewide procurement process.

The "aggregation of smaller customer groups" can only occur within a statewide procurement process if the "statewide" Default Service load is segmented into smaller tranches across electric utilities. In effect, this approach is no different that having the electric utilities procure supply for their own customers. Moreover, there is no "standardized contract" available for use in the New England market. Because of wholesale market rule changes and the entry of new players with a desire to conform the "standard contract" to fit their business objectives, negotiation of these contracts remains necessary. Although time consuming, the Company's experience is that this process actually increases the number of participants in the Request for Proposals, and therefore, has a positive impact on the level of competition in the process. Accordingly, neither of these "benefits" warrants consideration of a statewide procurement process.

While the benefits of moving to a statewide procurement process are marginal, at best, the cost of moving to a statewide process has the potential to be significant, both in terms of increased prices for customers and increased administrative and transactions costs for competitive suppliers, the distribution companies and the Department. A significant effort would have to be made to: (1) identify, qualify and finance an entity that would be charged with coordinating the process, which would add a cost that is not currently incurred under the existing program; (2) resolve issues relating to creditworthiness reviews of suppliers participating in the statewide process (i.e., which entity is responsible for reviewing and confirming creditworthiness, the companies or the solicitation manager?); (3) resolve issues relating to implications for distribution company credit facilities (i.e., which may have restrictions regarding the financing of purchases made to benefit customers of other distribution companies); and (4) determine how supply contracts will be executed given that individual companies and suppliers currently negotiate company-specific contract terms through the RFP process. In the end, resolution of these issues will lead to increased costs. See, Select Energy at 6.

When the arguments for a statewide procurement process are evaluated on a critical basis, it becomes clear that the benefits of moving to a statewide procurement system are negligible and, in fact, contravene the Department's well-established policy regarding the implementation of initiatives that are aimed at helping suppliers to compete rather than encouraging the development of competition market structure. At the same time, a statewide procurement process poses potential risks and costs to both the companies and their customers that are unnecessary to incur, especially where there is no benefit to be gained. Accordingly, the Department should reject the recommendations made by the Attorney General, DOER and others to establish a statewide process for the procurement of Default Service electric supply.

(4) Would smaller customers be better served if power supply for Default Service was procured using an auction process (e.g., descending clock) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an auction process to procure Default Service. In particular, please discuss whether using an auction is likely to produce lower Default Service prices.

As an initial matter, it is important to note that the support for a statewide auction process comes from the same entities supporting the statewide procurement process and, in fact, several commenters suggest that these two concepts are linked. See, National Grid at 13; DOER at 15. See also, Select Energy at 6 (noting that the two concepts are linked but not advocating for change to a statewide process). As noted by commenters in the proceeding, auction processes are generally used where a number of contracts are being bid upon simultaneously or the aim is to establish a uniform winning price for while maintaining the option of having more than one winning bidder. National Grid at 13; DOER at 15. Thus, the use of an auction process need only be considered in the event that the Department has determined that a statewide procurement process should be implemented. As noted by NSTAR Electric, National Grid and other commenters in this proceeding, the current RFP process is a robust competitive process and works well when utilized on a company-specific basis. National Grid at 13.

The Attorney General claims that an auction process would benefit smaller customers because more bidding information is made available to the bidders and that lower price bids would result. Attorney General at 7. The Attorney General also notes that a "descending clock auction" process would be a "relatively complex procurement" compared to closed bid auctions, such as the RFP process currently used by the electric companies. Id. at 8. Despite its complexity, the Attorney General advocates (without any basis) that an "open bid" process will produce a lower cost for customers than a "closed bid" or RFP process. As noted by the electric companies actually conducting the solicitations under the current system, the experience has been that there is a substantial level of competition in the RFP process and that the negotiations taking place as a result of those solicitations enable the companies to play one bidder off against another to achieve the lowest price. Thus, the "complexity" of the auction process will only have the effect of increasing transactions costs for both suppliers and distribution companies. Accordingly, unless the Department has identified an overriding benefit that warrants the implementation of a statewide procurement process, there is no justification for the substitution of the auction process for the RFP process currently used by the companies.

(5) Although the term "default service" is statutory, G.L. c. 164, §, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?

On January 13, 2005, NSTAR Electric filed a letter with the Department requesting early action by the Department in relation to a change in the name of Default Service on customer bills. The vast majority of commenters in the proceeding agreed that the use of the term "Basic Service" would be beneficial to minimize customer concern and confusion. Attorney General at 8; DOER at 16; National Grid at 14; Morgan Stanley at 8; Select Energy at 7; Unitil at 7; WMECo at 16-17. Accordingly, NSTAR

Electric reiterates its request for approval of this change in nomenclature on customer bills.

V. CONCLUSION

NSTAR Electric appreciates the opportunity to submit reply comments in this proceeding and looks forward to further participation in the Department's consideration of Default Service issues.